

Short-Term Bond Fund (A)

Second Quarter 2010

Quarterly Commentary

Ticker	Investment Advisor	Benchmark	Morningstar Category	Investment Objective
PLTBX	Principal Global Investors	Barclays Capital Govt/Credit 1-3 Index	Short Term Bond	Corp Bond - High Quality

Economy & Market Overview

Following four positive quarters in a row, both U.S. and international stocks fell in the second quarter of 2010. The rally ended as investor concerns mounted about economic stability in Europe, slowing growth in China and the sustainability of the U.S. recovery.¹

Europe's troubles, which started with the revelation of Greece's staggering deficit and debt load, broadened as it became apparent other countries (such as Spain and Portugal) faced similar issues. Markets reacted negatively to the exposure of European banks to the sovereign and corporate debt of these countries, despite the nearly \$1 trillion bail-out plan put in effect by the European Union and International Monetary Fund. In China, the government's decision to reign in real estate growth weighed on international investors, as did new data indicating a slowdown in China's pace of economic growth.²

Negative economic data reported during the quarter pointed to slowing growth across the U.S. economy: Employers continued their reluctance to add staff; May payrolls were meager, following gains in April and March.³ Gross Domestic Product (GDP) for the first quarter came in lower than expected; the 2.7% gain was a sharp drop from the 5.6% increase for fourth quarter 2009.⁴ After rising for three consecutive months, consumer confidence fell unexpectedly in June, reflecting consumers' uncertainty about jobs and income.⁵ Following expiration of the home buyer tax credit in April, new-home sales fell in May to a seasonally adjusted, annual rate of 300,000 (the lowest number since the government began tracking the figure in 1963);⁶ meanwhile, existing-home sales fell 2.2% in May after gaining 8% in April.⁷

After its June meeting, the Federal Reserve reaffirmed its belief that economic recovery is proceeding, but also acknowledged that "financial conditions have become less supportive of economic growth" and restated its intention to keep the fed funds interest rate very low "for an extended period."⁸

For the quarter, the broad U.S. stock market posted a return of -11.3% as all sectors within the Russell 3000 Index delivered negative performance. The economically sensitive materials sector struggled the most. Financial stocks also were under acute pressure, as investors grappled with the changing landscape of regulatory reform and how it might impact the industry. In this environment, growth and value performed similarly among large- and mid-cap stocks, while within small-caps, value slightly underperformed growth. From a market-cap perspective, small-caps outperformed large-caps.⁹

International stocks in developed markets returned -14.0%,¹⁰ reflecting in part the precarious financial situation in Europe. Emerging markets performed better, but still delivered -8.37%.¹¹

Real estate investment trusts returned -4.0%¹² to outperform the broad U.S. stock market. Although real estate fundamentals were still unfavorable, access to capital for commercial real estate had improved, which drew investors hoping to participate in the asset class's recovery.

Within fixed income, risk aversion was apparent as many investors turned to the "safe haven" of U.S. Treasuries, which outperformed other fixed-income sectors. By quarter-end, the yield on the benchmark 10-year Treasury had fallen from 3.84% to 2.95%. (Bond prices and yields move in opposite directions.) Meanwhile, investment-grade corporate bonds fell -2.25% relative to duration-adjusted Treasuries. Returns were slightly worse in the financial segment of the corporate bond market (down 2.97% relative to duration-adjusted Treasuries), due in part to uncertainty and anxiety surrounding financial regulation reform. Commercial mortgage-backed securities and asset-backed securities also lagged Treasuries, while mortgage-backed securities managed to outperform Treasuries by 0.01%.¹³ Finally, high-yield bonds returned -3.86% relative to duration-adjusted Treasuries, with the lowest-rated (highest risk) high-yield bonds performing the worst.¹⁴

Not FDIC or NCUA insured

May lose value • Not a deposit • No bank or credit union guarantee
Not insured by any Federal government agency

Performance Contributors

Positive Contributors

During last quarter:

The portfolio performed strongly during the period, driven primarily by security selection. Sector selection also contributed positively due to an out-of-index allocation to asset-backed securities (ABS). Additionally, rates fell during the quarter, which resulted in positive performance from duration-positioning, as the portfolio was long in duration relative to its benchmark index, Barclays Capital Govt/Credit 1-3 Index.

During last 12 months:

Sector allocation and security selection both contributed positively for the 12-month period. Adding the most value were an out-of-index allocation to securitized assets (commercial mortgage-backed securities (CMBS) and ABS), an overweight to investment-grade corporate bonds and an out-of-index allocation to below-investment-grade corporate bonds. The portfolio's underweight to Treasuries also helped performance. Duration-positioning was a positive contributor as well; the portfolio was long in duration as rates fell over the period.

Negative Contributors

During last quarter:

The portfolio's overweight to investment-grade corporate bonds was a slight detractor from performance. Also, an out-of-index allocation to below-investment-grade corporate bonds and an underweight to U.S. agencies and Treasuries contributed negatively to performance.

During last 12 months:

The portfolio's allocation to cash, while providing a liquidity cushion, detracted from performance. Also, while total sector allocation to investment-grade credit was a positive, within credit the portfolio's overweight to industrials was a negative as the sector underperformed the U.S. Corporate Investment Grade Index.

Changes to the investment option's structure or portfolio:

No material changes occurred in the portfolio structure.

Short-Term Bond Fund (A)

Performance

Investment results shown represent historical performance and do not guarantee future results. Investment returns and principal values fluctuate with changes in interest rates and other market conditions so the value, when redeemed may be worth more or less than original costs. Current performance may be lower or higher than the performance data shown. The gross fund expense figure does not reflect any waivers or caps on the mutual fund. Performance shown reflects the application of net expenses of the fund. For more performance information, including most recent month-end performance, visit principalfunds.com, or contact your financial representative of The Principal.

In situations where the net and gross fund expense figures are different, the investment manager has contractually agreed to limit the investment option's expense. Differences may also be shown due to the investment manager choosing to pay certain expenses that would normally be payable by the fund. The gross fund expense figure does not reflect any waivers or caps on the mutual fund. Performance shown reflects the application of net expenses of the fund.

Average Annual Total Returns (%) as of 06/30/2010	QTR	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date	06/28/2005
Short-Term Bond Fund (A) (excl. sales charge)	0.38	2.28	9.90	0.79	1.84	-	2.96	Ext. Perf. Inc. Date	12/06/2000
Short-Term Bond Fund (A) (incl. sales charge)	-1.86	-0.02	7.42	0.02	1.38	-	2.71	Total Inv. Exp Gross	0.82
Barclays Capital Govt/Credit 1-3 Index	1.05	1.95	3.77	5.13	4.52	4.76	-	Total Inv Exp Net	0.82
Short Term Bond Category	1.00	2.46	7.12	3.65	3.51	4.13	-	Waiver Date	-
Morningstar Percentile Ranking	-	-	16	90	91	-	-	Contractual Cap Date	-
Total Funds in Category	460	458	442	398	336	180	-	Contingent Deferred Sales Charge	-
								Maximum Up-front Sales Charge	2.25

Risk and Return Statistics Summary as of 06/30/2010

	3 Year Return vs. Rank						5 Year Return vs. Risk					
	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev	Alpha	Beta	R2	Sharpe Ratio	Info Ratio	Std Dev
Short-Term Bond Fund (A)	-2.95	0.67	3.98	-0.11	-0.79	5.50	-1.92	0.64	5.13	-0.19	-0.62	4.31

Relative to Barclays Capital Govt/Credit 1-3 Index

Risk and return statistical data is provided by Markov Processes International (MPI). Risk & Return Statistics Summary results are based on performance excluding sales charges. Percentile rankings are based on total returns in accordance with the appropriate Morningstar peer group. Please see Important Notes section for definitions of Risk and Return Statistics.

Short-Term Bond Fund (A)

Upside/Downside Capture Ratio Summary as of 06/30/2010

	3 Year Upside/Downside Capture Ratio						5 Year Upside/Downside Capture Ratio					
	# of Months		Avg Returns %		Market Benchmark %		# of Months		Avg Returns %		Market Benchmark %	
	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down	Up	Down
Short-Term Bond Fund (A)	21	15	0.20	-0.56	35.35	146.70	38	22	0.28	-0.42	54.69	143.64
Barclays Capital Govt/Credit 1-3 Index	30	6	0.58	-0.38	100.00	100.00	50	10	0.50	-0.29	100.00	100.00

Top Ten Holdings as of 05/31/2010

Security	Net Assets (%)
Federal Hm Ln Banks 1.625%	8.48
United States Treas Nts 1.125%	7.89
United States Treas Nts 1.375%	4.53
Kraft Foods 2.625%	1.82
Duke Engy Ohio 2.1%	1.70
Barclays Bk 2.5%	1.54
Blackrock 2.25%	1.52
Praxair 1.75%	1.50
Directv Hldgs Llc / Directv 6.375%	1.35
Thermo Fisher Scientific 144A 2.15%	1.29
Total % in Top 10	31.61

Information is current as of the date noted. Keep in mind that portfolio holdings are subject to risk.

Short-Term Bond Fund (A)

Manager(s)	Start Date	Degree	Alma Mater
Craig Dawson	03/01/2005	M.B.A.	University of Iowa
Timothy R. Warrick	12/31/2009	M.B.A.	Drake University

Fund Strategy

The investment seeks current income. The fund invests primarily in short-term fixed-income securities. It normally maintains an effective maturity of four years or less and a dollar-weighted effective maturity of not more than three years. The fund normally invests at least 80% of assets in investment-grade debt securities. It may also invest in below-investment-grade fixed-income securities.

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The value of the investment options will fluctuate so that when redeemed, shares or units may be worth more or less than the original cost.

Returns shown for periods of less than one year are not annualized. All returns displayed here are after Total Investment Expense of the investment option. Any operating expenses of a mutual fund or underlying mutual fund that are part of net Total Investment Expense are obtained from the mutual fund's most recent prospectus. The operating expenses shown as part of the Total Investment Expense include voluntary expense limits and fee credit.

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These calculated returns reflect the historical performance of the oldest share class of the fund, adjusted to reflect a portion of the fees and expenses of this share class. Please see the fund's prospectus for more information on specific expenses, and the fund's most recent shareholder report for actual date of first sale. Expenses are deducted from income earned by the fund. As a result, dividends and investment results will differ for each share class.

Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Neither the principal of bond investment options nor their yields are guaranteed by the U.S. government.

Fixed-income and asset allocation investment options that invest in mortgage securities are subject to increased risk due to real estate exposure.

Effective July 23, 2010, the Principal Short-Term Bond Fund will merge into the Principal Short-Term Income Fund.

Barclays Capital Govt/Credit 1-3 Index represents a combination of the Government and Corporate Bond indices with maturities between one and three years.

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Important Notes

Risk and Return Statistics:

Alpha - The difference between an investment's actual returns and its expected performance, given its level of risk (as measured by beta).

Beta - An investment's sensitivity to market movements.

R-squared - Ranges from 0 to 100 and reveals how closely an investment's returns track those of a benchmark index.

Standard Deviation - Measures how much an investment's returns are likely to fluctuate.

Sharpe Ratio - Measures how an investment balances risks and rewards. The higher the Sharpe ratio, the better the investment's historical risk-adjusted performance.

Information Ratio - A risk-adjusted measure commonly used to evaluate an active manager's involvement skill. It's defined as the manager's excess return divided by the variability or standard deviation of the excess return.

¹ Source: On the Other Hand: Economic Insights, Second Quarter 2010, by Bob Baur and the Principal Global Investors Economic Committee

² Source: The Conference Board Leading Economic Index® (LEI) for China, measuring economic activity, increased 0.3% in April following increases of 1.2% in March and 0.4% in February.

³ Source: U.S. Bureau of Labor Statistics: Employment Situation Summary 6/4/2010 (available at www.bls.gov)

⁴ Source: Bureau of Economic Analysis, US Dept of Commerce (data available at www.bea.gov)

⁵ Source: Data available at www.conference-board.org

⁶ Source: National Association of Home Builders (data available at www.nahb.com)

⁷ Source: National Association of Realtors (data available at www.realtor.org)

⁸ Source: Federal Reserve press release dated 6/23/10 (available at www.federalreserve.gov)

⁹ Source: As measured by Russell family of indexes

¹⁰ Source: As measured by the MSCI EAFE Index

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Important Notes

¹¹ Source: As measured by the MSCI EM Index

¹² Source: As measured by the MSCI U.S. REIT Index

¹³ Source: As measured by components of Barclays Capital Aggregate Bond Index

¹⁴ Source: As measured by components of Barclays Capital High Yield Index

This report is not complete unless all pages, as noted below, are included.

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